Internal Revenue Service
memorandum

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Br2:LSMannix

date: SEP 12 1991

to: District Counsel, Chicago CC:CHI
Attn: James M. Cascino

from: Assistant Chief Counsel (Tax Litigation) CC:TL

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subject: [redacted]

This is our response to your request for Tax Litigation advice, dated June 26, 1991. It is our understanding that the [redacted] affiliated group's taxable year ended [redacted], is currently under examination and the extension of the statute of limitations expires on [redacted]. It is also our understanding that the Alaskan Native Corporations with which [redacted] entered into transactions under the authority of section 60(b)(5) of the Tax Reform Act of 1984 (as amended by section 1804(e)(4) of the Tax Reform Act of 1986) in [redacted]'s taxable year ended [redacted], are also currently under examination and that the examinations will not be completed before [redacted].

ISSUES

1. Whether income assigned from the [redacted] affiliated group to various Alaskan Native Corporations ("ANC's"), under section 60(b)(5) of the Tax Reform Act of 1984 (as amended by section 1804(e)(4) of the Tax Reform Act of 1986), in excess of the ANC's losses and credits, "springs back" to the [redacted] group and must be reported in the [redacted] group's consolidated return.

2. If the excess income "springs back" to the [redacted] group, what language should be used in the [redacted] group's notice of deficiency to put the excess income in the [redacted] group's consolidated return for their taxable year ended [redacted].

CONCLUSION AND RECOMMENDATION

Any income assigned by the [redacted] group to the ANC's in excess of the ANC's losses and credits as finally determined by the Service "springs back" to the [redacted] group and must be reported in the [redacted] group's consolidated return. Also included below is suggested language for the [redacted] group's notice of deficiency.

FACTS

[redacted] entered into transactions under the authority of section 60(b)(5) of the Tax Reform Act of 1984 (as amended by section 1804(e)(4) of the Tax Reform Act of 1986) with a number of different ANC's during [redacted]'s taxable year ended [redacted]. You have sent us the documents for two of these transactions: one involving [redacted]'s wholly owned subsidiary, [redacted], and [redacted], an ANC, and the other involving [redacted]'s wholly owned subsidiary, [redacted], and [redacted]. The Team Coordinator for the [redacted] audit has stated that all of the transactions involving [redacted] and the ANC's were similar. We will only present the facts of the transaction involving [redacted] and [redacted]. However, our analysis and conclusions with respect to that transaction also applies to the other transactions.

According to the materials you sent us, the facts of the [redacted] and [redacted] transaction is as follows. During [redacted]'s taxable year ended [redacted], it filed a consolidated return with a number of affiliated corporations. In the [redacted] group's year ended [redacted], the [redacted] group assigned income to [redacted] under the authority of section 60(b)(5) of the Tax Reform Act of 1984 (as amended by section 1804(e)(4) of the Tax Reform Act of 1986) in an amount equal to the amount of the losses and credits originally claimed by [redacted] and its affiliates on their [redacted] consolidated tax return. The [redacted] group assigned the income to [redacted] through the means of a subsidiary called [redacted].

On [redacted], [redacted], at the time a wholly owned subsidiary of [redacted], issued [redacted] shares of Series A preferred stock to a wholly owned subsidiary of [redacted], called [redacted] ("[redacted]"), for a total purchase price of $[redacted]. At the time, [redacted] owned all [redacted] shares of [redacted] common stock. The estimated fair market value of [redacted] at that time was $[redacted]. The purchase of [redacted] shares of Series A preferred stock by [redacted] allowed it to elect [redacted] out of the [redacted] corporate directors of [redacted] and gave it, at least in form, [redacted]% of the voting control of [redacted].

However, [redacted]'s exercise of its voting control was extremely limited. First, the preferred stock was subject to a mandatory redemption at a price of $[redacted] per share on the earlier of the date [redacted] earned the amount of income [redacted] intended to assign to [redacted] or [redacted]. The preferred stock was, in fact, redeemed by [redacted] on [redacted]. Second, at the time of the issuance of the preferred stock, [redacted] had the sole option to purchase at any time [redacted] shares of Series B preferred stock from [redacted]. If [redacted] exercised this option, it would immediately gain voting control of [redacted] because the Series B preferred stock would allow it to elect the four directors allowed to be elected by the Series A preferred stockholders and it would give [redacted] in excess of [redacted]% of voting control over [redacted] on all other matters. Third, all major corporate actions, other than electing directors, required an affirmative vote of [redacted]% of all classes of [redacted] stock, the common and preferred stock voting as a single class. (Each share of [redacted] common and preferred stock was entitled to one vote per share.) Thus, even if [redacted] did not exercise its option to purchase [redacted] shares of Series B preferred stock, [redacted] could not authorize any major corporate action without the consent of [redacted]. Fourth, [redacted] had a right of first refusal to purchase the preferred stock owned by [redacted].

During the period that [redacted] was a member of [redacted]'s affiliated group, income earned by [redacted] in the normal course of its business was included on the consolidated tax return of the [redacted] affiliated group and was not included on the tax return of the [redacted] affiliated group.

After the above described transactions were executed, [redacted] received a letter ruling from the Chief Counsel's Office stating that [redacted] was allowed to once again join in the consolidated return filed by the [redacted] affiliated group starting on the date the preferred stock held by [redacted] was redeemed by [redacted]. [redacted] received similar letter rulings from the Chief Counsel with respect to the same type of transactions it had entered into with the other ANC's here at issue. No letter ruling was issued to [redacted] that addressed the viability of an assignment of income or the viability of an affiliation of a [redacted] subsidiary with an ANC, like the affiliation of [redacted] with [redacted] outlined above.

The Commissioner is currently auditing [redacted]'s [redacted] through [redacted] taxable years. The Service intends to disallow certain losses and credits claimed by [redacted], of which the largest disallowance relates to the valuation of certain timber property. Because the Commissioner intends to deny the losses claimed by [redacted], the income originally assigned by the [redacted] group to [redacted], through [redacted] as outlined above, exceeds the amount of [redacted]'s redetermined losses. Similarly, the Commissioner intends to reduce the losses claimed by the other ANC's here at issue and this results in the same type of overassignment of income from the [redacted] group to the other ANC's. Thus, the issue presented here is whether this excess income should "spring back" to the [redacted] group and be reported on its consolidated tax return.

DISCUSSION

Prior to 1985, I.R.C. § 1504(a) stated that a corporation was part of an affiliated group that qualified to file consolidated returns if 80% of its voting stock and 80% of each class of its nonvoting stock was held by the common parent of the group or another member of the group the owner of whose stock met the same test. The term "stock" for this purpose did not include nonvoting stock that was limited and preferred as to dividends. As part of the Tax Reform Act of 1984, Congress amended section 1504(a) by stating that the 80% ownership requirement meant ownership of 80% of the voting stock and 80% in value of both the voting and nonvoting stock of the corporation. Tax Reform Act of 1984, Pub. L. No. 98-369, § 60, 98 Stat. 494, 577-579. Congress also stated that for this purpose, the term "stock" does not include stock that is nonvoting, nonconvertible, and limited and preferred as to both dividends and in liquidation.

As part of the Tax Reform Act, Congress also exempted certain corporations and transactions from the new section 1504(a) affiliation rules. One such group was ANC's. Section 60(b)(5) of the Act stated:

> The amendments made by subsection (a) shall not apply to any Native Corporation established under the Alaskan Native Claims Settlement Act (43 U.S.C. 1601 et seq.) during any taxable year beginning before 1992 or any part thereof in which such Corporation is subject to the provisions of section 7(h)(1) of such Act (43 U.S.C. 1606(h)(1)).

Although the legislative history to the statute is silent, the purpose of section 60(b)(5) was to allow ANC's to sell their losses to profitable corporations, in a manner similar to the transactions here at issue, thereby benefiting the financially troubled ANC's. The financial incentive to the profitable corporations for entering into the transactions was that their tax liabilities were reduced. However, section 60(b)(5) was not considered sufficient for this purpose and, as part of the Tax Reform Act of 1986, Congress replaced the statute with the following provision:

> (A) In the case of a Native Corporation established under the Alaskan Native Claims Settlement Act (43 U.S.C. 1601 et seq.), or a corporation all of whose stock is owned directly by such corporation, during any taxable year (beginning after the effective date of these amendments and before 1992), or any part thereof, in which the Native Corporation is subject to the provisions of section 7(h)(1) of such Act (43 U.S.C. 1606(h)(1))--

(i) the amendment made by subsection (a) [of section 60 of the Tax Reform Act of 1984] shall not apply, and

(ii) the requirements for affiliation under section 1504(a) of the Internal Revenue Code of 1986 before the amendment made by subsection (a) shall be applied solely according to the provisions expressly contained therein, without regard to escrow arrangements, redemption rights, or similar provisions.

(B) Except as provided in subparagraph (C), during the period described in subparagraph (A), no provision of the Internal Revenue Code of 1986 (including sections 269 and 482) or principle of law shall apply to deny the benefit or use of losses incurred or credits earned by a corporation described in subparagraph (A) to the affiliated group of which the Native Corporation is the common parent.

(C) Losses incurred or credits earned by a corporation described in subparagraph (A) shall be subject to the general consolidated return regulations, including the provision relating to separate return limitation years, and to section 382 and 383 of the Internal Revenue Code of 1986.

(D) Losses incurred and credits earned by a corporation which is affiliated with a corporation described in subparagraph (A) shall be treated as having been incurred or earned in a separate return limitation year, unless the corporation incurring the losses or earning the credits satisfies the affiliation requirements of section 1504(a) without application of subparagraph (A).

Tax Reform Act of 1986, Pub. L. No. 99-514, § 1804(e)(4), 100 Stat. 2085, 2801. The 1986 amendments are effective as if included in the 1984 Act. Pub. L. No. 99-514, § 1881, 100 Stat. 2914.

The Conference Committee Report to the 1986 amendments states:

The conference agreement also provides that, during the applicable transition period, the affiliation requirements of the consolidated returns provisions will be applied to Alaskan Native Corporations (and their wholly owned subsidiaries),..., solely by reference to the express language in those provisions. Thus, eligibility for affiliation in the case of such corporations will be determined solely on the basis of ownership of stock satisfying the 80-percent voting power and 80-percent nonvoting tests, without regard (for example) to the value of the stock owned, to escrow arrangements, voting trusts, redemption or conversion rights, stock warrants or options, convertible debt, liens, or similar arrangements, or to the motive for acquisition of the stock or affiliation.

In addition, with certain specified exceptions, no provision of the Internal Revenue Code or principle of law will be applied to deny the benefit of losses or credits of Native Corporations (or their wholly owned subsidiaries) to the affiliated group of which the corporation is a member or of the specified group of corporations, during the applicable transition period. Thus, in general, the benefit of such losses and credits may not be denied in whole or in part by application of section 269, section 482, the assignment of income doctrine, or any other provision of the Internal Revenue Code or principle of law.

H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-1, II-843, 1986-3 vol. 4 C.B. 1, 843.[1]

No less than 39 ANC's that were assigned income from one or more profitable corporations under the authority of section 60(b)(5) of the Tax Reform Act of 1984 (as amended by section 1804(e)(4) of the Tax Reform Act of 1986) have been audited or are presently under audit by the Service. Although other variations exist, some of the transactions were much like the transaction here at issue. Approximately 26 letter rulings were issued to taxpayers who engaged in transactions under the authority of section 60(b)(5) of the Tax Reform Act of 1984 (as amended by section 1804(e)(4) of the Tax Reform Act of 1986). Of these, approximately 22 contain language to the effect that any income assigned by a profitable corporation to an ANC in excess of the ANC's losses "springs back" to the profitable corporation and must be reported on the profitable corporation's tax return.

A substantial portion of the losses claimed by the ANC's, which were used to offset the assigned income, were with respect to timber property. A substantial portion of these claimed losses were or are being disallowed by the Service. Thus, the instant issue--Whether the excess income "springs back" to the profitable corporation--is present in virtually all such cases.

The "spring back" rule was developed in the context of certain transactions executed under the authority of section

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[1] The Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 5021, 102 Stat. 3342, 3666-3668, repealed section 60(b)(5) of the Tax Reform Act of 1984 (as amended by section 1804(e)(4) of the Tax Reform Act of 1986) generally for losses or credits which arise after April 26, 1988.

60(b)(5) of the Tax Reform Act of 1984 (as amended by section 1804(e)(4) of the Tax Reform Act of 1986), like the transactions at issue here, in which the profitable corporation's tax rate for the year from which the income was assigned was higher than the ANC's tax rate for the year to which the income was assigned--because the profitable corporation's tax year was pre-Tax Reform Act of 1986 and the ANC's year was post-Tax Reform Act of 1986. In such cases, "tax rate arbitrage" could occur, wherein profitable corporations would attempt to assign excess income to ANC's in order to have the income taxed at a lower rate. Technical determined that the profitable corporation could only assign income up to the amount of the ANC's losses and credits. Any excess income that was assigned to the ANC's would "spring back" to the profitable corporation and be included in its return and taxed at its tax rate.

The specific rule of law upon which the "spring back" rule rests is that section 60(b)(5) of the Tax Reform Act of 1984 (as amended by section 1804(e)(4) of the Tax Reform Act of 1986) only applied to income assigned by a profitable corporation up to the amount of an ANC's losses and credits and, likewise, the prohibition in section 1804(e)(4)(B) against the use of sections 269 and 482, assignment of income principles or any other principle of law only applied up to the amount of the ANC's losses and credits. Any amount of assigned income in excess of the ANC's losses and credits would be included in the profitable corporation's income pursuant to the normal application of sections 269 and 482, assignment of income principles or other relevant principles of law.

In the transaction at issue here, and the other ones we have examined, we believe that the excess income should be included in the return filed by the profitable corporation. These transactions included situations in which the profitable corporation transferred unaccrued rights to income to a subsidiary controlled jointly by the profitable corporation and the ANC; the profitable corporation transferred an asset to such a subsidiary and then purchased an option to purchase the asset at a grossly inflated price; the profitable corporation entered into sham service contracts to assign income to the ANC; and, as in the transactions at issue here, the profitable corporation transferred formal control of an income producing subsidiary, while at the same time putting restrictions on the ANC's control of the subsidiary and then regaining full control a short time later. No income assigned by a profitable corporation in excess of the ANC's losses and credits should remain with the ANC in such cases.

In cases where there was merely an assignment of receivables or other assignment that clearly would be impermissible under assignment of income principles, we think that the technically correct answer is that the excess income should "spring back." Furthermore, the Service should treat ANC's that received such assignments but that cannot rely on letter rulings consistently with ANC's that received such assignments and can rely on letter rulings. In this context, it should also be noted that Technical has informed us that the technically correct answer is that the excess income should "spring back" and that it is unwilling to alter any of its letter rulings in order to amend or delete the "spring back" language.

In the cases where there was a transfer of stock of a corporation that contained income producing property, as in the transactions at issue here, the assignment of income doctrine arguably does not apply. However, other principles of law would apply to require any excess income to "spring back." Because in virtually all of these transactions their was no business purpose or economic substance for the transactions, the transactions were entered into for no other reason but to assign income to the ANC's, the profitable corporations retained substantial control over the stock transferred to the ANC's and the ANC's only owned the stock for a short period of time, it can be argued that the transfers were tax shams and, therefore, section 60(b)(5) of the Tax Reform Act of 1984 (as amended by section 1804(e)(4) of the Tax Reform Act of 1986) does not apply; i.e., in so far as there was income in excess of the ANC's losses assigned to the ANC's. See Elko Realty Company v. Commissioner, 29 T.C. 1012 (1958), aff'd per curiam, 260 F.2d 949 (3d Cir. 1958); American Pipe & Steel Corporation v. Commissioner, 25 T.C. 351 (1955), aff'd, 243 F.2d 125 (9th Cir. 1957), cert. denied, 355 U.S. 906 (1957), J.D. & A.B. Spreckels Company v. Commissioner, 41 B.T.A. 370 (1940); Book Products Industries, Inc. v. Commissioner, T.C. Memo. 1965-65; R.P. Collins & Company, Inc. v. Commissioner, 303 F.2d 142 (1st Cir. 1962), aff'g 193 F. Supp. 602 (D. Mass. 1962). In all the above cited cases, an acquired corporation could not join in the filing of the consolidated return of the purchasing group because the transfer lacked business purpose and was merely to take advantage of a corporation's losses.

It should be noted that the argument in the types of transactions at issue here would have to be that with respect to the income assigned by the profitable group in excess of the ANC's losses and credits, the particular subsidiary generating the income is treated as still in the profitable corporation's affiliated group and the excess income would be reported in the profitable group's consolidated return. None of the above cited cases, however, held that the acquired corporation had to continue to include its income in the consolidated return of a selling group.

However, only one of the above cited cases, Book Production Industries, addressed the situation in which the acquired corporation left an affiliated group that filed consolidated returns and none of the cases addressed the situation in which the acquired corporation left a consolidated group and returned to the group a short time later. Furthermore, none of the cases addressed the issue of whether the acquired corporation should continue to be included in the selling group's consolidated returns. Therefore, the fact pattern and issue presented here was not addressed in the above cited cases. We believe that the above cases, although somewhat distinguishable, would still be precedent for requiring that income assigned by a profitable group to an ANC in excess of the ANC's losses and credits in the types of transactions at issue here would be reported on the profitable group's return rather than on the ANC group's return because the transactions lacked business purpose.[2]

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[2] Additionally, it should also be noted that [redacted]'s representatives have argued that if the excess income is not included in the ANC group's consolidated return, neither would it be in the [redacted] group's consolidated return but, rather, the subsidiary that generated the income would stand alone with respect to the excess income. Furthermore, the representatives argue that the statute of limitations for assessing the subsidiary would have already expired. First, if the subsidiary is treated as standing alone for purposes of the excess income, its statute of limitations would not have expired (at least in the case of [redacted]). The reasoning for this conclusion is as follows. Treas. Reg. § 1.1502-75(g) provides that where a common parent files a return for a consolidated group and erroneously includes therein an ineligible subsidiary, that return is treated as being a filed separate return as to the ineligibly included subsidiary. That is, the subsidiary is treated as having filed a separate return at the time the parent filed the consolidated return for the group. Treas. Reg. § 1.1502-77(c) provides that where a common parent files a waiver of the statute of limitations for a consolidated group it operates to also extend the statute of limitations for an ineligibly included subsidiary. Thus, the statute of limitations for [redacted] for its stand alone period for the excess income (if the court should determine the excess income is not included in the [redacted] group's consolidated return) would be the normal statute of limitations of the [redacted] group plus any extention periods covered by a waiver executed by the common parent of the [redacted] group. We understand that the statute of limitations of the [redacted] group is still open for a short period of time considering only the normal statute of limitations plus waiver periods, if any. Any other subsidiaries of [redacted] as to which there will be a spring back problem and where it is an operating subsidiary should be examined under the above

Additionally, it could also be argued that the Service is prohibited from making the above argument in these cases by section 1804(e)(4)(A)(ii) of the Tax Reform Act of 1986. As discussed above, section 1804(e)(4)(B) of the Tax Reform Act of 1986 prevents the Service from using section 482 or 269, or other principle of law to deny the use of ANC's losses and credits and, based on this paragraph, the Service's position is that it is permitted to use those provisions or principles to "spring back" the assigned income in excess of the ANC's losses and credits. But section 1804(e)(4)(A)(ii) prohibits the Service from using any arguments to attack the affiliation of a corporation with an ANC and section 1804(e)(4)(A)(ii) makes no reference to ANC losses. The legislative history to the 1986 provisions seems to support this argument. The Conference Committee Report states: "Thus, eligibility for affiliation in the case of such corporations [ANC's] will be determined solely on the basis of ownership of stock satisfying the 80-percent voting power and 80-percent nonvoting test, without regard...to the motive for acquisition of the stock or affiliation." H.R. Conf. Rep. No. 841, 1986-3 vol. 4 C.B. at 843. The Service's argument in the fact pattern at issue here attacks the affiliation of a corporation with an ANC and does not simply apply sections 482 or 269, or some principle of law to "spring back" the excess income. This is also a litigation hazard for the Service in these cases.

The counter argument is that the above argument makes a distinction without a difference and that the purpose of the legislation must be viewed as a whole. First, it can be argued that Congress' intent in enacting section 60(b)(5) of the Tax Reform Act of 1984 (as amended by section 1804(e)(4) of the Tax Reform Act of 1986) was to allow profitable corporations to assign income to ANC's up to the amount of the ANC's losses and that it was not Congress' intent for profitable corporations to assign income to ANC's without any reference to the ANC's losses and credits. To interpret the statute differently could lead to extremely abusive situations. Second, in a case were there is clearly an assignment of income, section 1804(e)(4)(B) permits sections 482 or 269, or some other principle of law to apply to "spring back" income in excess of the ANC's losses and credits. Third, simply arguing that the transaction in which an income producing subsidiary is transferred to the ANC is a tax sham and

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rationale to see if the statute of limitations would be open for purposes of putting the excess income (as an alternative) in the subsidiary on a stand alone basis. Secondly, it may be prudent to, in the alternative, treat the subsidiary as standing alone and issue a notice of deficiency to it for the excess income where the statute of limitations is still open for that purpose under the above rationale.

that the subsidiary is still a member of the profitable corporation's affiliated group to the extent that there is excess income is not a materially different argument and promotes the general purpose of the statute. Therefore, even in situations were income producing subsidiaries are transferred to ANC's, any income in excess of the ANC's losses and credits that is generated by the subsidiary should be included in the consolidated return of the profitable corporation group and for this purpose the subsidiary should be treated as being included in the profitable corporation's group.

Furthermore, with respect to the transactions we have examined, we think it unreasonable to make a distinction between ANC's that structured their transactions with profitable corporations in such a way as to require a substance over form, sham transaction or business purpose argument to recast the transaction and ANC's that entered into transactions that were clearly assignments of unaccrued income. The benefits and burdens of section 60(b)(5) of the Tax Reform Act of 1984 (as amended by section 1804(e)(4) of the Tax Reform Act of 1986) should be applied consistently in these cases without reference to the form of the transactions.

Applying these principles to the case at issue, any income assigned by the [redacted] group to [redacted] in excess of [redacted]'s losses and credits as finally determined by the Service--such excess resulting from a recomputation of [redacted]'s losses during its audit by the Commissioner--"springs back" to the [redacted] group and must be included in the consolidated return of the [redacted] group. For this purpose, [redacted] is included in the [redacted] affiliated group only to the extent of the excess income. This same conclusion applies to the other transactions entered into by the [redacted] group with the other ANC's here at issue.

We acknowledge that some exposure exists with respect to this position. However, legal principles require us to take the position that the excess income "springs back," at least with respect to the transactions we have examined. We are satisfied with the spring back position and would object to any settlement that leaves excess income with the ANC.

With respect to your question concerning the proper language in the statutory notice of deficiency to be issued to the [redacted] group asserting that the excess income is included in its consolidated return, we recommend stating:

> The income assigned by the [redacted] group to [redacted] [and the other ANC's here at issue] during its year ended [redacted], pursuant to the various tax sharing agreements entered into under the authority of section

60(b)(5) of the Tax Reform Act of 1984 (as amended by section 1804(e)(4) of the Tax Reform Act of 1986), in excess [redacted]'s [and the other ANC's] losses and credits as finally determined by the Service is included in the consolidated return filed by the [redacted] group.

If you have any questions, please contact Alfred C. Bishop, Jr., at FTS 566-3520 or Lawrence S. Mannix at FTS 566-3470.

Marlene Gross

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